Russia: A user's manual for crisis situations

BEITEN BURKHARDT

© BEITEN BURKHARDT Rechtsanwaltsgesellschaft mbH, 2015

Russia: A user's manual for crisis situations

BEITEN BURKHARDT

Dear partners,
dear friends!

German companies have been successfully investing in the Russian economy for decades. They sell their products on the Russian market, set up representative offices and subsidiaries, participate in joint ventures with Russian partners, build factories, and establish manufacturing facilities in Russia. German companies are represented in 81 regions of the largest country in the world. No other foreign business community is as broadly represented in Russia as the German community.

Recent events in and related to Ukraine have not only affected political relations between Russia and Germany, but have had a direct effect on the economy. The policy of sanctions has been compounded by falling oil prices and the associated drop in the value of the ruble. Higher prices on imported goods have affected not only direct deliveries from abroad but also Russian domestic production, in cases when it used imported raw materials and consumables or manufacturing equipment.

These events have affected the activities of German companies to a significant extent. They are facing the issue of how the situation will reflect on existing contractual relations and on contracts planned for the future; what factors they must take into account when granting payment deferrals to a Russian partner; and what means of securing the performance of obligations they can use in such cases to protect the interests of German companies.

At the same time, when carrying out investment projects an ever greater number of German companies must take into consideration current and planned localization policies in Russia. A localization policy may end up being quite beneficial to a number of enterprises, since the Russian economy is in dire need of modernization and diversification. Russia is strongly interested in creating favorable investment conditions; this can be seen by the fact that Russia has significantly climbed the ranks in the World Bank's Ease of Doing Business Report, according to which over the past two years Russia has manage to rise from 122nd position to 62nd, due to improvements in the framework conditions for doing business. In addition, the Russian regions are actively participating in a "foreign investors' race", competing among themselves to attract foreign investment.

In recent months we have encountered numerous questions and concerns from representatives of a number of companies regarding current events. Certain of these questions are general in nature, and this is why we have prepared this publication. It provides an overview of the main (legal) aspects that should be taken into consideration when operating in Russia, in order to meet the current challenges and face 2015 with preparations well in hand.

Should you have any additional questions, we would be pleased to hear from you directly.

Falk Tischendorf
Lawyer, Partner
Head of the Moscow office
of BEITEN BURKHARDT

Contents

1. Contract management 5

2. Corporate issues 9

3. Real estate 13

3.1 Advantages for the tenant 13

3.2 Is the developer always right? 15

4. Labor law issues 18

5. Actions to take in the event of a legal dispute 22

6. Actions to take in the event of a debtor's bankruptcy 25

7. Conclusion 27

1. Contract management

Operations in the Russian market are based first and foremost on contracts. It makes no difference whether we are talking about delivering goods or large-scale local manufacturing. Given the current situation, what aspects need to be taken into account when discharging existing contracts and concluding new ones?

Again about the money… How to finance my project?

Financing projects is one of the most difficult challenges at present. Companies are faced with the important question of how to finance transactions that they have already entered into. Major Russian banks have been cut off from access to financial markets, and the Central Bank of Russia has raised the key lending rate to 17% per annum. As a result, the lack of necessary financing has turned out to be conditional on not only a lack of trust but also a lack of money. Many companies are already taking measures to stave off the consequences of insufficient financing. The following measures may be useful in this respect:

Monitoring of counterparties

A thorough check of your counterparty's solvency is a key condition for the successful implementation of projects and effective assurance that any emerging claims will be satisfied, and not only in times of crisis.

Information on your counterparty can be obtained from public sources.

For example, in only few minutes you can request an electronic excerpt from the Unified State Register of Legal Entities on the website of the Federal Tax Service (www.nalog.ru). Among other things, this excerpt will provide information on the participants and general director of the company, the size of its charter capital, to the extent of which the company is liable for its obligations, and also the domicile of the company.

Information on current litigation involving your partner can be obtained at the website of the Supreme Court of the Russian Federation (www.arbitr.ru). In addition, there are a large number of other sources of information that can be used to review your counterparty.

What are the requirements on contractual documentation?

Whereas during good times parties generally do not think too deeply about contractual documentation, contracts can be of decisive significance during periods of crisis and given the threat of nonpayment by a counterparty. However, it is only at such times that many companies think to ask themselves how scrupulously they have approached the drafting of contractual documentation with the Russian client, and also whether this documentation meets the requirements of Russian law.

The main rule is as follows: all contracts with Russian clients, including all amendments and addenda, must be drafted in simple written form. This rule applies even in those cases where contracts are not governed by Russian substantive law.

If there is no such written contract, and obligations have been discharged on your part but the Russian client has not made payment under the contract, the chance of successfully satisfying your claims for payment through the courts is vanishingly small. In the absence of contractual documentation (or if there are substantial shortcomings in the contracts concluded), it can be difficult and sometimes impossible to satisfy claims. In this case, it can be quite difficult in practice to find an appropriate legal remedy for emerging problems.

Can I effectively secure my claims?

If a German company makes deliveries with deferral of payment, i.e. fulfills its obligations first, thereby providing the customer with a «commercial credit», its risks under such a transaction grow.

The question then arises: how can claims under a transaction with a Russian party be secured? Russian law foresees a number of such means of securing the performance of obligations.

- One of such means is a pledge, which under Russian law can be drawn out without transferring tenure to the pledge holder. To secure the payment obligations of the Russian client, any asset belonging to the client or a third party may be transferred under pledge. This may be equipment, goods in circulation, real estate, equity interests in a company, and also rights under a bank account agreement.
  As a rule, only the conclusion of the relevant pledge agreement is required to establish a pledge. For this reason, the time costs and financial costs involved in transferring assets under pledge are fairly manageable. When real estate properties or the rights of a participant in a company are being pledged, it should be kept in mind that due to state registration requirements an additional two to three weeks will be required.
  If payment obligations are not discharged, then as a rule the pledged asset is sold at auction, and the creditor receives satisfaction of its claims from the funds generated by the asset's sale. As an alternative, a provision often stipulates that the creditor may keep for itself the object of the pledge, if the creditor is interested in this asset.
- In addition to pledges, consideration should also be given to individual means of securing the performance of obligations, which include sureties and bank guarantees, for example.
  As a rule, a surety is provided by the parent company of the debtor or a party related to it. The conclusion of a surety agreement is a necessary condition for creating a surety. Such means of securing obligations as the provision of a letter of guarantee from the parent company, as is commonly done in German practice, do not exist in Russian law. For this reason, under Russian law the provision of a letter of guarantee does not create appropriate security for the performance of obligations, and accordingly its use is not recommended in practice.

«Ruble panic» (the falling exchange rate)

The latest upheavals on the financial market have also given rise to many causes for concern. Many companies have been affected by the fluctuations in the exchange rate. As a result, in practice Russian clients have begun to demand amendments to contracts or their cancellation.

From a legal point of view, changes in exchange rates do not constitute grounds for amending or canceling the contract. In recent years the higher courts have primar-

ily considered exchange rate fluctuations to be a business risk, since a company that concludes contracts in euros or US dollars should be aware that exchange rates are subject to change. References to force majeure or to changes in market conditions are unjustified in this case.

Nonetheless, even if exchange rate fluctuations are of no significance from the legal point of view, companies would still do well to find a solution for the longer term that takes into account the interests of both parties in the event of changes to the exchange rate. In such cases, it is possible to stipulate in a contracting agreement what actions should be taken in response to exchange rate fluctuations or to include a provision on adjusting prices if the exchange rate deviates from the Central Bank exchange rate that was in effect when the agreement was concluded.

In addition it is possible to create a contractual obligation to change prices in response to changing exchange rates, or to agree on a provision on automatic price changes in line with changes in exchange rates.

When does force majeure occur?

If an unusual situation arises in the course of company's business activities, one immediately hears talks of force majeure (acts of God).

However, it is important to understand what force majeure is from the legal point of view and when an unusual situation can be classified as force majeure. Under Russian law, a contracting party that cannot perform its obligations as a result of the onset of force majeure circumstances is exempt from liability for violating its obligations.

At the same time, not every difficult situation is necessarily a case of force majeure. The situation can only be considered a case of force majeure when it is extraordinary, i.e. it goes beyond the normal course of business and could not be foreseen by the parties, and it could not be prevented, i.e. it was objectively (not subjectively) beyond the power of the parties to prevent it. For example, it is not force majeure if a supplier is unable to deliver goods as a result of the fact that its own sub-supplier delays in discharging its obligations. The law assumes that in such cases the supplier can choose other sub-suppliers and thereby discharge its assumed delivery obligations. In accordance with the practice of superior courts, financial crises, high levels of inflation, and changes in market conditions or legislation also do not constitute force majeure.

If in a specific case it is not possible to execute a contract, it is essential to review whether the aforementioned conditions are met (that the situation is extraordinary and could not be prevented). At the same time, it is of no significance whether the text of the contract indicates the corresponding circumstances as force majeure, since simply classifying a specific circumstance as force majeure in a contract is still insufficient for it to be recognized as such.

In practice, the existence of force majeure circumstances is usually confirmed by the chamber of commerce and industry. Such confirmation is issued by written request. This request is usually accompanied by a copy of the contract and documents issued by the competent authorities confirming the existence of force majeure circumstances

(a certificate of the customs authorities on an import/export ban, etc.). Confirmation of the existence of force majeure circumstances is issued within two weeks.

In addition, the aforementioned circumstances are not recognized as a material change in circumstances from which the parties proceeded when concluding the contract, and which gives the parties the right to cancel the contract through the courts. This court practice was developed during the financial crisis of 1998 and confirmed during the crisis periods of 2008/2009.

Threat of sanctions?

In connection with the fact that mutual sanctions have affected a number of companies, the question arises: how should one behave under sanctions, and how should the difficulties that companies face be countered?

First of all, it is essential to review whether a specific counterparty and/or a specific transaction falls under the effect of sanctions.

If they are covered by the sanctions, then it's time to consider taking the appropriate legal measures. Under current Russian court practice, the introduction of sanctions is considered to be a force majeure circumstance.

Accordingly, one should immediately inform counterparties of the onset of force majeure circumstances. It is also essential to obtain confirmation from the competent authority.

In the event of the possible introduction of additional sanctions, it is recommended that contracts include a provision on the legal consequences of violating the contract as a result of the effect of sanctions, and also to stipulate a provision on the unilateral disclaimer of the contract and performance of mutual settlements.

2. Corporate issues

The current situation also affects corporate relations. Some German companies have their own subsidiaries in Russia that work with their Russian partners. Others create joint ventures with their Russian partners. The current economic instability in Russia and the world could directly or indirectly affect these companies founded in Russia. For this reason, it is recommended that, at the least, a strategic assessment of their business activity be performed.

Below we will turn our attention to some of the most typical situations commonly encountered in practice, which are generally of great importance for doing business in Russia.

Under what conditions can cash be paid to a German parent company (Cash-Pooling)?

Despite the Russian government's repeated assurances that no currency restrictions will be placed on capital exports, many foreign investors keep the monetary funds of their Russian subsidiaries in a foreign currency.

For starters, a Russian subsidiary can make dividend payments to a foreign participant. According to the general rule, this distribution of profit may be performed on a quarterly basis, once every six months or once per year, assuming of course that there is net profit and a decision on its distribution. In addition, the Russian subsidiary can make a prepayment to a foreign parent company or other foreign company that is part of the concern for the future shipment of goods.

The Russian subsidiary can also issue a loan to a foreign parent company or other foreign company within the corporate group. That being said, it should be kept in mind that according to Russian tax law a Russian subsidiary and a foreign parent company or other foreign company within the corporate group are considered to be related parties. Related-party transactions are subject to control based on Russian transfer pricing rules. For example, the tax authorities may review whether the transaction price corresponds to the market price. If the transaction price does not correspond to the market price, the market price is used for tax purposes. Russian tax law does not clearly stipulate that transfer pricing rules apply to loan agreements, and, among other things, it is unclear whether interests are included in the transaction price. The Russian tax authorities and the Ministry of Finance of Russia proceed in their activities on the premise that the transfer pricing rules are applicable to loan agreements. However, there is currently no relevant court practice on this issue. Therefore, the interest rate under a loan agreement must correspond to the generally accepted market interest rate. Otherwise, there will be a risk that the tax authority applies a different interest rate. The interests calculated in this way increase the income tax due and payable by the Russian subsidiary. In addition, fines and late payment interests may also be charged. The Russian subsidiary must inform the tax authorities of the conclusion of transactions prior to 20 May of the following year; it must also be able to document that the interest rate on the loan is a market rate.

How can the existing debt of a Russian subsidiary be restructured? / Restructuring of an intragroup loan

The material depreciation of the ruble compared to the euro and US dollar is causing serious damage to Russian companies with debt to foreign companies in euros or US dollars. This is especially relevant for loan obligations and leads to an increase in debt in ruble equivalent, adverse foreign exchange differences and, therefore, to losses.

How can the resultant problems be solved?

If we are talking about a so-called intragroup loan, the option of converting the loan into the equity capital of the subsidiary can be explored.

Restructuring is possible through (full or partial) debt forgiveness or by converting debt into additional paid-in capital of the Russian company (as a contribution to property).

Legal and tax aspects must be kept in mind when selecting an appropriate solution. In any case, the solutions, which may create additional tax liabilities, for example, in situations of debt forgiveness, should be avoided.

Each case should be considered individually, to find the optimal solution.

Under which circumstances is the parent company liable for the actions of a Russian subsidiary?

If a foreign parent company has the ability to issue instructions to a subsidiary and, thereby, to influence its operating activity, it bears joint and several liability on the debts and obligations of the Russian subsidiary that arise in connection with the execution of these instructions. This problem may be especially pressing under the conditions of the current crisis, since many German companies proceed from the premise that a Russian subsidiary acts as a sort of buffer enabling the parent company to escape liability. However, it should be noted that in those cases where the right to issue instructions exists, in certain circumstances the counterparty of a Russian subsidiary will be entitled to file claims against the German parent company. The right to issue instructions may follow, for example, from an agreement with the subsidiary, the charter of the subsidiary or as a result of dominant participation in the charter capital of the subsidiary.

In which cases is the general director of the Russian company liable? Are there specifics which should be taken into account due to the existing sanctions?

Under the conditions of the emerging crisis, the following two cases of liability of the general director of a Russian company take on special importance:

First of all, the question arises of the degree to which the general director can be held personally accountable based on the German law On Regulation of Foreign Economic Relations if the Russian company under his management sells goods that may be subject to the sanctions. In particular, this issue arises when most of the equity interests/shares in the company being managed thereby belong to Russian participants or shareholders.

In this case one should remember that Russian corporate law has priority over European norms. This means that, in case of doubt, liability will not arise if there is a relevant decision of the general meeting of participants or shareholders prescribing the performance of actions that violate the sanctions.

Secondly, in case of the threat of insolvency (bankruptcy) of the Russian company, its general director is required to submit a bankruptcy petition (to initiate bankruptcy proceedings).

This rule is in effect, inter alia, in cases where:

- the satisfaction of the claims of one or more creditors would make the discharge of the company's obligations to other creditors in full impossible;
- a decision on liquidation and filing of a debtor's bankruptcy petition has been taken by the company's authorized body;
- recovery of the company's property would make its business activity significantly more difficult or impossible;
- if the company is showing signs of insolvency (termination of payment of part of obligations due to the lack of monetary funds) or insufficient assets (debt exceeds the value of the company's property (assets)).

In these cases the debtor's bankruptcy petition (to initiate bankruptcy proceedings) should be filed immediately, no later than one month after the onset of these circumstances. If this obligation is not fulfilled, the general director of the Russian company will bear secondary liability on any obligations which arise after the expiry of the term stipulated for filing the debtor's bankruptcy petition.

What do I need to remember if my subsidiary was founded in the form of the now discontinued closed joint stock company (ZAO)?

The continued operation of a closed joint stock company (ZAO) will be associated with increased administrative expenses. As a part of the reform of corporate law, starting from 1 September 2014 ZAO will continue to exist as private joint stock companies.

Now the adoption of resolutions at the general meeting of shareholders will require the confirmation of a licensed registrar or notary public. The maintenance of a shareholders' register can no longer be performed by the company itself, and must be transferred to a licensed registrar. A mandatory audit of an AO must be performed on an annual basis.

In this regard, it makes sense to consider the possibility of converting a ZAO into a limited liability company (OOO), all the more so because the procedure for conversion was simplified considerably. An OOO has the following advantages over an AO:

- the adoption of resolutions of the general meeting of participants of an OOO can be confirmed by a notary public or in some other way established in the charter or in a unanimous decision of the general meeting itself;
- an audit is only mandatory for an OOO in certain cases stipulated by the law (for instance, if profit from the sale of goods in the previous reporting year exceeded RUB 4 million or the carrying value of assets at the end of the previous reporting year exceeded RUB 60 million);
- an OOO independently maintains the list of its participants.

Right now no information or notices to creditors need to be published in case of conversion. Accordingly, creditors are not entitled to demand the early performance or termination of the relevant obligations.

What do I need to do if I am no longer in a position to maintain equity capital?

The adverse effects of the crisis may lead to a situation in which the equity capital of a Russian subsidiary falls below its charter capital or even below the minimum amount of charter capital established by the law.

Based on the most recent amendments, from 1 September 2014 a company's net asset value at the end of the second and each subsequent financial year must be no lower than the amount of the subsidiary's charter capital. Otherwise, the company must either increase its net asset value to the amount of the charter capital according to the established procedure or reduce the charter capital to the amount of its net assets or adopt a resolution on liquidation. Therefore, net asset value must be tracked in real time and, if necessary, measures must be taken to level them off.

If a corporate group of companies owns several subsidiaries in Russia, the subsidiaries could be merged to reduce administrative expenses. If individual subsidiaries work at a profit, while others work at a loss, such a merger could reduce the tax burden in Russia.

What are the innovations regarding the pledge of the property of a company?

A new improved pledge legislation, which took into account the requirements of commercial practice, entered into force on 1 July 2014. The movable property of the debtor or of a Russian subsidiary to be pledged can now be used as an effective security mechanism.

The law now stipulates the pledge of movable property to be indicated in the register maintained by public notaries (register of notices on the pledge of movable property, see https://www.reestr-zalogov.ru), which should ensure the transparency of pledge and protection of the rights of the pledge holder. Despite the fact that the recording of pledge rights to movable property is performed on a voluntary basis and the absence thereof does not affect the legal relations between the pledgor and the pledge holder, the record keeping is highly recommended. This record keeping is necessary, first and foremost, to determine the seniority of pledge. The claims of the pledge holder secured by the pledge are satisfied in the order in which they were included in the register of notices on the pledge of movable property, regardless of the time of their occurrence. Claims that are not included in the register of notices on the pledge of movable property are satisfied last. As an exception, claims secured by the pledge of movable property under agreements concluded prior to 1 July 2014 and included in the register prior to 1 February 2015 inclusively will be satisfied based on the date of conclusion of the agreement. Moreover, the registration of the pledge of movable property in the register is necessary to exclude the risk of termination of pledge in case the pledged property is alienated by the pledgor. According to the general rule, the right of pledge is terminated on the acquisition of the pledged property for consideration by a bona fide purchaser. However, if the right of pledge has been included in the pledge register, the acquirer is considered a bad faith purchaser. To prevent the possibility of good faith acquisition, the right of pledge must be recorded in the register of notices on the pledge of movable property immediately after the conclusion of the pledge agreement. When concluding transactions on the acquisition of movable property, an examination must now be performed of whether or not this property has been pledged pursuant to the data of the register of notices on the pledge of movable property. The pledge holders under pledge agreements on movable property concluded prior to 1 July 2014 should provide information on the rights of pledge for the register of notices on the pledge of movable property prior to 1 February 2015. Otherwise, the seniority of the pledge will be determined based on the date of entry in the register.

3. Real estate

The current crisis will first and foremost affect leasing and contracting obligations. As a result of the devaluation of the ruble, relations between tenants and landlords frequently become a source of tension, since leasing rates have mainly remained unchanged. In this situation, it is recommended that the following aspects be kept in mind:

3.1 Advantages for the tenant

In a crisis the real estate market becomes a tenant's market. As a rule, it becomes possible to cut costs. Many tenants demand that landlords reduce lease rates and/or include additional services in the lease payment. In turn, landlords defend their own interests.

Under what conditions can a tenant demand a reduction in lease payments?

The following rule generally holds for lease agreements: Unless otherwise stipulated by law or contract, the amount of the lease payment may be amended by agreement of the parties before deadlines determined in the lease agreement, but not more than once per year.

As a rule, the landlord stipulates a mechanism in the contract under which the lease payment may be changed unilaterally at the demand of the landlord, but only upwards (for example, in the event of a change in the ruble exchange rate against foreign currencies to which the lease payment is tied, or increased inflation). Such mechanism for changing the lease payment does not violate the law, but of course it takes into account only the landlord's interests.

The landlord should keep the following in mind in this regard:

- If under the lease agreement the landlord has the right to unilaterally change the amount of the lease payment, then such changes may be made by him not more than once per year;
- If as a result of the unilateral change the lease payment increases disproportionately to the change in average market rates for the lease of similar properties in this location for the same period, and substantially exceeds them, this attests to the abuse of this right by the landlord. In this case the courts may refuse to allow the landlord to collect lease payments in the part exceeding the respective average market rates.

However, in a crisis situation, landlords often voluntarily agree to lower lease payments, even if signed contracts do not compel them to do so. The main goal is not to lose tenants in a declining lease market.

Under conditions where the ruble exchange rate is volatile, tenants may demand that landlords reduce the amount of the lease payment and/or set the maximum foreign cur-

rency exchange rate to the ruble at which the lease payment may be recalculated. In the retail sector, there are also cases where tenants demand cancelling the base (fixed) lease payment and calculating a lease payment as a percentage of turnover generated by the tenant on the premises, and/or setting a ceiling for the lease payment tied to turnover.

To properly justify a demand for lower lease payments and the conditions for the reduction, it is recommended to engage real estate consultants. Lease agreements frequently contain arbitration mechanisms under which the landlord and tenant jointly engage a real estate consultant (from a specific predetermined list of companies) to resolve issues on the fair amount of the lease payment.

When can a dispute on the amount of the lease payment be referred to the courts for consideration?

If parties would like to ensure that in the event it is not possible to agree on changes to the lease payments out of court they can refer this issue for consideration to a court, then they should explicitly stipulate in the lease agreement the possibility of referring such dispute to courts. Otherwise the court will not satisfy the claims in question.

Substantial exchange rate fluctuations or increased inflation do not constitute grounds for the tenant to not discharge its contractual obligations or to demand a change in the lease amount in court. Nonetheless, this does not rule out the possibility of the parties voluntarily reaching an agreement on reducing the lease payment in response to the market situation. In this respect, the tenant retains the ability to cancel the lease agreement on the basis of provisions related to the proposal to conclude a new agreement on different terms.

When is it possible to cancel a lease agreement?

The law permits the following options for terminating the agreement:

- by agreement of the parties;
- by refusal of one of the parties to perform the agreement. Such refusal is possible only if explicitly stated in the agreement. The possibility of such refusal is usually tied to a material violation of the lease agreement. The refusal to perform the agreement may be disputed by another party in court;
- by submitting a petition to cancel the agreement in court.

Grounds for cancelling a lease agreement in court in the event of a material violation of its terms is stipulated explicitly in the Civil Code of the Russian Federation, but may also be stated in the agreement. However, it is recommended that the tenant keeps the following in mind:

The landlord has the right to demand early cancellation of the lease agreement in court if more than two times in a row the tenant has not made the lease payment at the end of the established payment date. Even after lease payment arrears have been settled, the landlord still has the right to file a claim for the cancellation of the agreement within a reasonable time. However, the failure to make such claim within a reasonable time after the tenant settles arrears on lease payments will deprive the landlord of the right to demand cancellation of the lease agreement in connection with this violation. The reasonableness of the time for submitting a petition to cancel the lease agreement is determined by the court, taking into account the specific circumstances of the case. For this reason, it is better to pay on time.

3.2 Is the developer always right?

During crisis periods clients rapidly reduce their capital expenditures on construction, which for a contractor may take the form of a full or partial refusal to perform a contract. In addition, there may be delays in the payment for work.

Does the client have the right to reduce the scope of work and, if so, by how much?

The law contains only provisions regarding in which cases and to what extent the client may increase the scope of work. The client has the right to make changes to the technical documentation, provided that the value of the additional work caused by such amendment does not exceed 10% of the total value of construction indicated in the budget schedule, and does not change the nature of the work stipulated in the construction agreements. In other words, the client may increase the scope of work (for example order additional work), but not by more than 10% of the value and without changing the nature of the work. Increases in work over 10% are permitted only by agreement of the parties. In both cases, the increase in the scope of work leads to a change in the contract price.

The legislation does not contain a direct answer to the question of whether the client can unilaterally reduce the scope of work. The only exception is the law governing the procedure for state procurements, which allows the parties to a state contract to change the scope of work by mutual consent, including reducing it, by 10%.

Because a reduction in the scope of work could be considered a partial refusal to perform the contract by the client, the general rules of the Civil Code of the Russian Federation apply, pursuant to which the client may refuse to perform the contract at any time before the results of the work are delivered, paying the contractor the value of the work already performed before the notification of the client's refusal to perform the contract is received. However, the following conditions apply to the client's exercise of this right:

- the right to refuse to perform the contract has not been excluded by agreement of the parties;
- the client is obligated to compensate the contractor for losses caused by the termination of the construction agreement, within the bounds of the difference between the price determined for the work as a whole and the part of the price paid for work already performed.

The parties also have the right to establish a fixed amount which will be due to the contractor as compensation for losses in the event of a unilateral refusal to perform the contract by the client.

Thus, the issue of the client's right to unilaterally reduce the scope of work remains unregulated by law and may be agreed by the parties in the construction agreement.

Does the client have the right to demand changes of a firm contract price and, if so, by how much?

A firm price for work is frequently established when a construction agreement is concluded. However, when work is performed it may become clear that in fact the work was performed by the contractor at a price lower than that stipulated by the contract. Does the client have the right in this case to demand the work to be paid for at its actual cost?

The law does not permit such demand by the client. The contractor does not have the right to demand an increase in the firm price, and the client does not have the right to demand its reduction, even in cases where it was not possible when the construction agreement was concluded to stipulate the full scope of the work to be performed or the required expenses.

In what cases does the contractor have the right to demand an increase in a firm price?

In the event of a substantial increase in cost of materials and equipment, as well as third-party services, which could not have been foreseen when concluding the agreement, the contractor has the right to demand an increase in the established price, and if the client refuses this demand, to cancel the construction agreement. The criteria for the materiality of an increase in costs is decided on by the court, taking into account the circumstances of the specific case. In so doing the court takes into account the indexes of changes in the budgeted cost of construction work, materials, and equipment published by the state authorities. However, the courts are extremely conservative in their approach to assessing the materiality of cost increases and also other circumstances that the contractor must show to have taken place to justify its right to unilaterally cancel the contract in connection with changing circumstances (for example the fact that the cost increase could not be foreseen).

What steps can the contractor take if payment is delayed?

In this case, it is possible to collect liquidated damages for a delay in payment. If the construction agreement does not stipulate liquidated damages, the contractor has the right to collect legally permitted interests on the unpaid amount.

However, the effectiveness of liquidated damages as means of pressuring the client should not be overestimated: Practice shows that the client ceases to pay when it starts to experience financial difficulties, and this means the prospects for quickly receiving liquidated damages are doubtful.

Other than liquidated damages, the contractor does not have many options:

- suspension of work;
- cancellation of the construction agreement.

Work may be suspended in whole or in part, depending on how much of the work was not paid for. At the same time, the contractor has the right to submit a claim to the client for losses caused by the suspension of work.

Such losses may be substantial. Frequently clients experiencing financial difficulties deliberately do not resort to the lawful but extremely costly and lengthy procedure of mothballing an incomplete construction, but rather attempt to transfer the current expenses and risks of maintaining the incomplete construction to the contractor. Contractors may accept these conditions in hope that the project will soon be resumed and they will receive the expected profits. In construction projects, the parties are in no hurry to be involved in extended court proceedings. Unfortunately, no general recommendations can be given here for how the contractor should act. Rather it is important that the contractor make a professional assessment of the situation and evaluate its readiness to exit an unprofitable project at the right time.

Real estate pledge (mortgage) – is it reliable means of securing the performance of obligations?

The real estate pledge (mortgage) represents classic means of securing the performance of obligations. If for example the debtor does not discharge its obligations under the agreement, the pledge holder has the right to satisfy its monetary claims against the debtor under this obligation from the value of the pledged real estate property. However, in the event of bankruptcy, the pledge holder frequently ends up in a situation where it becomes impossible to sell the pledged asset at an acceptable price.

Currently, the law foresees two possibilities for foreclosing on pledged assets:

- through courts;
- out of court.

In both cases it is permitted to sell the mortgaged asset at auction. However, at present there is a risk that due to the crisis it will be difficult to find a buyer, or that the property will be sold at a understated price. It is also possible to manage the asset until the crisis is over. Many banks chose this option during the 2008/2009 crisis.

At the same time, foreclosing out-of-court offers greater opportunities. For example, the parties may agree that the pledge holder may retain for itself the pledged property after foreclosure. Such (out-of-court) foreclosure on pledged assets is possible only if stipulated in the mortgage agreement. In the following cases out-of-court foreclosure is not permitted, and thus the foreclosure is only possible through courts:

- title to the pledged asset is held by an individual;
- the pledged asset is the subject of a prior or subsequent mortgage, under which a different procedure for foreclosure applies to the pledged asset, or there are different means of selling the pledged asset;
- the property is pledged to secure the performance of different obligations to different co-mortgagees;
- the subject of the mortgage is a land plot taken from lands designated for agricultural use, on which there are no buildings or structures;
- the subject of the mortgage is a land plot taken from lands designated for agricultural use, provided to a citizen for individual residential construction;
- the subject of the mortgage is a land plot owned by municipal authorities or the state, the boundaries of which have not been established and on which there are no buildings or structures;
- the subject of the mortgage is an asset in state or municipal ownership;
- the borrower's right to the pledged asset has not been registered with the Unified State Register of Title to Real Estate and Transactions Therewith (EGRP);
- the subject of the mortgage is an asset that has significant historical, artistic or cultural value to society.

In order to ease the sale of properties for the creditor, we recommend notarizing a mortgage agreement that contains a provision on the out-of-court foreclosure procedure, although the law does not establish this requirement. In this case registration entries in the EGRP when the pledged asset is sold may be entered on the basis of the executory endorsement of the notary.

4. Labor law issues

In the current challenging situation, many entities are striving to streamline their expenses. It goes without saying that expenses on personnel play an important role here. What legal possibilities to optimize personnel costs can the company use?

What should be taken into account during a downsizing and staff reduction?

The employer is entitled to:

- refrain from an economic justification for the performance of a reduction. A staff reduction is a right of the employer. This right is only limited by the need to follow the procedure established by law;
- bring in contract personnel or persons performing their activities based on civil law agreements to perform the functions of employees who have been downsized, with due account for the restrictions established by law;
- hire a new employee to take the place of a downsized employee if economic conditions or labor terms change, or to increase the qualification requirements for the new employee compared to the previously downsized employee.

In this regard, the employer is required to:

- determine the employees included in protected categories of employees (for example, pregnant women, single mothers, persons having the priority right to remain in their job compared to other employees holding the same position based on their work productivity and qualifications). Protected employees may only be dismissed on special grounds, such as an agreement of the parties or the refusal of the employee to continue working in connection with a change in the working conditions;
- notify employees of termination against signature at least two months in advance (in case of a mass layoff, the notice must be given at least three months in advance). The employees shall be paid wages during the period between the notice and dismissal;
- pay severance pay and the average monthly salary for the period of job placement, but usually not for more than three months after dismissal.

Can the wages of an employee be unilaterally reduced?

The wages of an employee may be unilaterally reduced, provided that certain conditions are met:

- The grounds for reducing wages must be organizational or technical changes in the entity's operations (for example, a structural reorganization and the resultant reassignment of employees or redistribution of job responsibilities, a reduction in the amount of serviced equipment). In this regard, it should be noted that the unfavorable financial and economic situation of the employer caused by crisis developments cannot serve as the only reason for a unilateral change in the terms of an employment contract;
- A reduction in the amount of wages must be accompanied by a reduction in the number of job responsibilities/scope and difficulty of work and/or a reduction in working hours;
- An employee must be notified of the upcoming changes in writing at least two months in advance, with an indication of the reasons for the changes.

If an employee does not agree to work on the new terms and cannot be transferred to a suitable vacant position (provided that any exist), he may be dismissed. That said, he must be paid minimum severance benefits of average wages for two weeks. Dismissal on the indicated grounds is also allowed in relation to protected categories of employees who cannot be dismissed as part of a staff reduction.

Other terms and conditions may also be amended during the process of unilateral amendment of the terms of the employment contract (for example, the list of job responsibilities, the length of the working day and the performance plan for job responsibilities (with the exception, however, of labor functions)).

Can wages not be paid to employees in case of a forced suspension of production or operations due to a lack of orders?

Suspension of wages on these grounds is inadmissible. Insufficient workload of employees for economic reasons is a business risk of the employer. Therefore, the employer is entitled to introduce business interruption arrangements, but must pay employees compensation in an amount of at least 2/3 of average wages for the entire idle period.

An order is issued on the introduction of business interruption arrangements which is to be brought to the attention of employees against signature. The order must indicate that employees have the right to be present in the office/production facilities during the idle period. The unemployment service also usually needs to be informed of the business interruption.

As an alternative to a business interruption, some employers force their employees to submit requests on the provision of unpaid vacation. This practice violates the law and causes serious risks for the employer.

The option of sending employees on paid vacation can also be considered. In practice, many employees accumulate a large number of unused vacation days during their period of employment. For the employer to not pay the compensation for unused vacation on dismissal, an employee may use these days during a downturn in business activity or the suspension of production.

Can a fixed-term employment contract be concluded with an employee if there is uncertainty about whether this employee will be ensured long-term employment?

Under Russian legislation, the conclusion of a fixed-term employment contract is only allowed in those cases established by law (for example, to perform definite declared work). A fixed-term employment contract concluded in the absence of sufficient grounds to do so may be recognized in court as having been concluded in perpetuity. This rule is also in effect in a situation where several fixed-term contracts (for example, for one month) were concluded with an employee. When considering the case, the court may classify the legal relations that arise as a single employment contract concluded for an unlimited term.

In practice, the established restrictions on the conclusion of fixed-term employment contracts can be overcome by concluding an agreement on termination of the employment contract after a set period together with the employment contract, provided no pressure is put on the employee to conclude this agreement. However, despite its technical admissibility from the standpoint of the law, this option is not recommended for use, since after the conclusion of an agreement on termination the employer will most likely not be able to unilaterally dismiss the employee on other grounds, even in case of culpable actions on his part.

The use of leased personnel can be considered as another alternative. However, the use of leased personnel will be prohibited in Russia as a general rule starting from 2016. The following are exceptions to this rule: 1) performance of work related to a knowingly temporary (up to nine months) expansion of production or scope of services, and 2) replacement of a temporary absent employee (for example, an employee on childcare leave).

What opportunities arising in a crisis period should we pay attention to?

A crisis entails not only the necessity to cut costs, but also opportunities to improve the entity's work efficiency, including:

- Optimization of the personnel structure, dismissal of ineffective employees, redistribution of duties;
- Bankruptcy, liquidation or reduction in the business activity of entities frees up a large number of highly qualified specialists who can be hired for work on terms advantageous for the company;
- Production downtime can be used to send employees to advanced training courses. To do so, the relevant agreement should be concluded with the employee, under which he will be required to work a certain period at the company or to repay the cost of training.

It should be noted that in crisis periods a large number of complaints are received from employees by the labor inspectorate/prosecutor's office or a court. The employer must be ready for this, and be able to support its position with duly drafted documents. In this regard, it is recommended that a review of human resources documentation be performed, and, if necessary, any significant gaps be filled.

What should I do if the funds on the account are insufficient to pay wages?

This situation is fairly rare in practice, but cannot be excluded in a crisis period. The following recommended steps can be singled out:

- Company management should discuss the existing situation with employees and assure them that the difficulties are temporary and technical in nature;
- To reduce the financial burden on the company, the possibility of an interruption of business should be considered;
- Do not allow a partial deferral of wage payments for more than three months, or a full deferral for more than two months. Otherwise, there is the risk of an audit and the instigation of a criminal case against the company director, director of the branch or the head of the representative office of the company.

When wage arrears are paid, they should be paid together with interest for each day of delay.

When planning dismissals, it is also important to keep in mind that all payments to an employee must be made no later than his last day of work. Accordingly, if the dismissal of a significant number of employees is planned, the amount of the payments should be calculated in advance and the relevant cash funds should be made available on the company's account. Delay in payment for even one day is considered a violation of labor legislation, and could result in the risk of the company's director/chief accountant being held administratively liable. In addition, a fine of up to RUB 50 thousand may be imposed for a violation of payment terms in relation to each dismissed employee.

Is the employer required to index wages of employees for inflation on an annual basis?

The indexation of wages is a guarantee for employees, aimed at protecting them from inflationary processes.

The employer is not required to index wages, unless this obligation has been established in a local normative act of the company, although the absence of such act may be seen as a violation of labor legislation.

The employer establishes the procedure for indexation independently (including the frequency of indexation, amount of indexation, differentiation of indexation based on the positions held by employees, etc.). In practice, indexation depends directly on the company's financial position.

The payment of bonuses and granting of wage raises (outside of indexation) also presupposes an increase in the actual wages of employees and can be considered as an alternative to indexation.

In practice, wages are often established in euros or US dollars, but paid in rubles. If the exchange rate of the ruble falls, this is advantageous for employees but not the employer if its goods are sold in rubles. In addition, the labor inspectorate is of the opinion that the fixing of wages in a foreign currency does not meet legislative requirements, since the position of the employee deteriorates in the event of a fall in the exchange rate.

5. Actions to take in the event of a legal dispute

Even a contract subjected to the most painstaking oversight and interim measures cannot eliminate the risk of a legal dispute. However, such steps can increase your chances of winning a court case and help to protect the company's interests. What do you need to consider in the event of a dispute?

Should I go to court or wait?

The crisis in 2008-2009 showed that many companies which had in the past performed all their contractual obligations to the letter would be transformed into deliberate nonpayers at a time of crisis. The reason was banal – the amount of contractual penalties was lower than the cost of credit that a company could use to perform payments or develop its business. Thus debtors were able to benefit economically by defaulting on contractual payments.

Today the cost of credit has also risen significantly, and once again motivation for suspending contractual payments is coming to the fore. Consider this motivation when you decide whether to file a claim in court.

It is also worth bearing in mind that recovering debt through court action is a complex matter. The timeframe alone of the judicial process in the first instance, which can take from three to six months, could result in the deterioration in the debtor's economic position and reduce accordingly the likelihood that the company will actually recover any debt. It goes without saying that the best option is to find a solution that is mutually beneficial. However, if the debtor shows no desire to look for a compromise, court action might serve as an additional incentive for the debtor to perform the obligations that it had assumed.

Securing a claim

Securing claims is an effective way for creditors to protect their rights, in particular during a crisis. Russian law makes it possible, when submitting a claim, to file a petition on securing the claim and to demand the arrest of the company's accounts and/or prohibit the disposal of specific property. The more substantiated the petition, the greater the chances that it will be satisfied by a court. Accordingly, you should keep an eye on any actions by the debtor aimed at asset stripping or replacing corporate control, and also other actions which could render the enforcement of a potential court order impossible, and mention these actions when preparing the respective petition.

What should I focus on when proving my claim?

Any claim should be backed by evidence. In view of the increasing risk of judicial disputes with counterparties, you should pay particular attention to the correct performance of obligations by the debtor and the documentation of the due performance of counter obligations by your company. Contracts, orders, transfer and acceptance certificates, acts on performed work, powers of attorney and other documents should be duly drafted and executed. The powers of the signatories should be verified. These actions simplify

the process of establishing the required evidence and minimize the risks of a challenge to the actual facts and the amount of the claim filed for recovery.

It is important to bear in mind that judicial disputes between businesses in Russia are considered first and foremost on the basis of an analysis of the written evidence; furthermore, at present courts do not always recognize electronic evidence (for example, emails, the data of electronic procurement systems, special software files, etc.) as appropriate evidence.

Can a court order be enforced in Russia?

Even in times of economic stability, enforcing a court order in Russia is a fairly complex task. However, this does not mean that the creditor should abandon all hope of satisfying its legal claims. The effectiveness of the procedure applied to enforce a court order in Russia also depends, inter alia, on the actions undertaken by the creditor. The likelihood that the creditor will successfully enforce a court order depends on the persistence of the creditor and the amount of information on the debtor's property that it provides to the court bailiff.

The decisions of Russian state courts are subject to unconditional enforcement in Russia. The awards of foreign arbitral (arbitration) courts are enforced on the basis of the provisions of the Convention "On the Recognition and Enforcement of Foreign Arbitral Awards" (New York, 1958).

The awards of foreign state courts (for example, German courts) may only be recognized and enforced on the basis of an international treaty to which the Russian Federation is a party. As a rule, such provisions are contained in bilateral treaties on the provision of legal assistance. The Russian Federation has concluded such treaties with virtually all the post-Soviet states, the overwhelming majority of countries in East Europe, and also some countries in West Europe, such as Spain, Italy and Finland. However, a corresponding bilateral agreement has not been concluded between the Federal Republic of Germany and the Russian Federation.

The issue of recognizing a foreign court award within the framework of an economic dispute is resolved by the commercial court of the constituent subject of the Russian Federation at the location of the debtor or its assets. In all other instances, a court of general jurisdiction decides on whether to recognize and enforce a foreign court award. If the award should be recognized in accordance with an international treaty, the competent court issues an award, which serves as the grounds for the compulsory enforcement of the corresponding award of a foreign court in Russia.

What enforcement measures are available?

The following methods can be used to enforce obligations:

- Levy of execution on the debtor's assets (including cash and securities);
- Levy of execution on regular payments received by the debtor by virtue of labor, civil law or social legal relations;
- Levy of execution on the property rights of the debtor (including exclusive rights to intellectual property and means of identification).

First and foremost, levy of execution is performed on the debtor's cash. This concerns both the cash on its bank accounts, and also cash in hand and other valuables. In view of the depreciation of the Russian ruble, enforcement might prove problematic, as the right of claim calculated in rubles should comply with the right of claim of the creditor denominated in another currency.

Levy of execution on the debtor's other assets is only performed if the debtor has no cash.

Levy of execution on the debtor's assets may be performed through:

- Attachment on the debtor's assets by compiling a list of its assets, establishing a ban on the disposal of the assets, and where necessary – a restriction on the right to use the assets;
- The forced sale of the debtor's assets through a specialized organization.

If the debtor is a legal entity, the levy of execution on its assets is performed in the following order of priority:

- Movable property not directly involved in the debtor's production process (including securities, finished products, precious metals and valuables);
- Property rights not directly involved in the production process of the debtor;
- Immovable property not involved in the production process of the debtor;
- Property rights directly involved in the production of goods, performance of work, provision of services, and also the assets involved in the production of goods (immovable property, equipment, raw materials, materials, etc.).

6. Actions to take in the event of a debtor's bankruptcy

In exceptional instances, the economic crisis may lead to the bankruptcy of Russian counterparties. Statistical data attest to a growing number of bankruptcy cases in 2014. What steps should you take in such a situation?

Statistical data of the resource pravo.ru (http://stat.pravo.ru/) show that the number of bankruptcy petitions in 2014 increased by 28% compared to 2013.

Year	Type of dispute:	Received		Returned		Accepted	
2013	Insolvency (bankruptcy)	29 107	-19%	8 390	-28%	25 827	-14%
2014	Insolvency (bankruptcy)	33 496	+28%	8 642	+15%	30 170	+30%

When can bankruptcy proceedings be commenced?

Bankruptcy proceedings may be commenced in respect of the debtor when the following terms and conditions occur simultaneously:

- The debtor is unable to meet the monetary claims of its creditors for 3 (three) months from the date when they should have been met. Furthermore, such claims may consist both of claims for the payment of monetary amounts (for example, in respect of transactions), and also state claims for the execution of statutory payments (taxes, fines, etc.);
- The total monetary claims in aggregate equal at least RUB 100,000;
- The claim is confirmed by the decision of a competent court that has entered into force.

Who may instigate bankruptcy procedures?

A bankruptcy may be instigated by the following individuals:

- The creditor;
- The competent state authority;
- The actual debtor.

When is the debtor required to file a petition with a commercial court on recognizing it as bankrupt?

The debtor is required to file a petition with a commercial court in the following instances:

- If as a result of the satisfaction by the debtor of the claims of one creditor or several creditors it is unable to execute its monetary obligations before other creditors;
- If the levy of execution on the debtor's assets complicates materially or renders impossible its business activities;
- If it is established during the liquidation of the company that the creditor's claims may not be satisfied in full.

In the aforementioned instances, the debtor should file the petition no later than one month after the date of the emergence of the corresponding circumstances.

Which courts are entitled to consider bankruptcy cases?

State commercial courts have exclusive jurisdiction over bankruptcy cases. Territorial jurisdiction is determined based on the location of the debtor. In other words, the commercial court at the location of the debtor will be the competent court.

What happens to outstanding claims in the event of bankruptcy proceedings?

The introduction of bankruptcy proceedings in respect of the debtor does not imply the automatic repayment of the claim. At the same time, the monetary claims of a creditor may only be submitted for enforcement within the framework of bankruptcy proceedings.

When you are concluding a transaction, you can minimize the risks related to the possible bankruptcy of the counterparty. For example, the claim of a secured creditor is considered separately and 70% of the revenues from the sale of pledged assets (80% – under claims arising from a loan agreement) will be paid to the secured creditor, while the remainder will be included in the bankruptcy estate and distributed between the remaining bankruptcy creditors. Other forms of security – bank guarantee, suretyship, insurance of business risks – also make it possible to protect the creditor's interests in the event of the debtor's bankruptcy. A company can also minimize its risks by performing financial due diligence of a potential counterparty before concluding the transaction.

What happens to unsecured claims in the event of bankruptcy?

The unsecured claims of the creditor are satisfied proportionately from the bankruptcy estate. The bankruptcy creditor is vested with extensive powers to control the bankruptcy proceedings, analyze the debtor's transactions and actions of the management of the debtor. If suspicious transactions aimed at the asset stripping are identified, the bankruptcy creditor has the option of initiating a challenge of the suspicious transactions and may also file a claim on holding the managers and participants of the debtor secondary liable in respect of the debtor's obligations.

What is the order of priority of claims in bankruptcy proceedings?

The claims of each category of creditors are satisfied after the claims of the previous order of priority have been satisfied in full. Creditor claims are satisfied with a priority ahead of other claims if they arose after the introduction of receivership proceedings by the commercial court, and also if the claims are related to expenses on the bankruptcy case and the payment of the fee of the court-appointed manager, and current payments.

After satisfying such priority claims, the remaining claims of creditors are satisfied in the following order of priority:

- Settlements are performed in the first order of priority further to the claims of individuals whose lives or health were impaired by the actions of the debtor through the capitalization of corresponding time payments, and also the compensation of moral damages;
- Settlements are performed in the second order of priority relating to the payment of severance pay and the wages of individuals who work or worked under an employment contract, and on the payment of consideration under copyright contracts;
- Settlements are performed in the third order of priority with other creditors.

What transactions may be recognized as invalid during bankruptcy?

1. The following so-called "suspicious" transactions may be recognized as invalid by virtue of the bankruptcy proceedings:

- transactions concluded by the debtor in the year prior to the acceptance of the petition to declare the debtor as bankrupt or after the acceptance of said petition, in the event of unequal consideration by the other party to the transaction;
- transactions concluded by the debtor in the three years prior to the acceptance of the petition to declare the debtor as bankrupt if the transaction aimed to cause property damage to creditors, and as a result of its conclusion damage was caused to the property rights of the creditor, and if the other party to the transaction knew about this goal of the debtor at the time of the conclusion of the transaction.

2. A transaction that results in priority treatment for one of the creditors (aimed at ensuring the security of the creditor's claims; aimed at changing the order of priority of the satisfaction of claims or the receipt of any other benefits) may be recognized as invalid:

- If it is concluded one month prior to the acceptance of the bankruptcy petition by the commercial court in any case;
- If it is concluded in the 6 (six) months prior to the filing of the bankruptcy petition if the interested party knew or could have known about the indicia attesting to the debtor's insolvency.

7. Conclusion

The current economic and political crisis sets new objectives and challenges for many companies. However, this crisis will not last forever. By appropriately assessing the situation and taking sensible precautions, you can mitigate the negative implications of the crisis and keep your business as sound as possible. Experience of the previous crises demonstrates that if events turn out fine, this crisis could also have positive results: it may help you improve your position on the Russian market, increase your market share and, consequently, create favorable terms for your business to perform even more successfully after the crisis than before.

Contact

BEITEN BURKHARDT Moscow
Turchaninov Pereulok 6/2, 119034 Moscow
Tel.: + 7 495 232 96 35
Fax: + 7 495 232 96 33
E-mail: Falk.Tischendorf@bblaw.com
BeitenBurkhardtMoscow@bblaw.com
www.beitenburkhardt.com

BEIJING • BERLIN • BRUSSELS • DUSSELDORF • FRANKFURT AM MAIN • MOSCOW
MUNICH • NUREMBERG • SHANGHAI • ST. PETERSBURG

WWW.BEITENBURKHARDT.COM